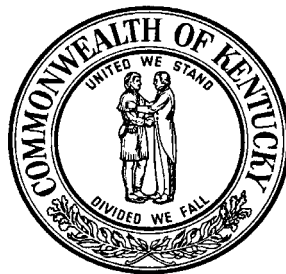


**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS
FINANCE AND ADMINISTRATION CABINET**

**In Reference to the Statewide Single Audit
of the Commonwealth of Kentucky**

For the Year Ended June 30, 2004



**CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS
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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Robbie Rudolph, Secretary
Finance and Administration Cabinet

MANAGEMENT LETTER

Pursuant to Kentucky Revised Statute (KRS) 43.090 (1), which states, "[i]mmediately upon completion of each audit and investigation, except those provided for in KRS 43.070, the Auditor shall prepare a report of his findings and recommendations," we are providing this letter to the Finance and Administration Cabinet to comply with KRS 43.090.

This letter presents the results of the work performed at the Finance and Administration Cabinet as part of our annual audit of the Commonwealth of Kentucky's financial statements.

In planning and performing our audit of the basic financial statements of the Commonwealth for the year ended June 30, 2004, we considered the Finance and Administration Cabinet's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving the internal control and its operation that we considered to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Finance and Administration Cabinet's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily disclose all matters that might be reportable conditions. In addition, because of inherent limitations in internal control, errors or fraud may occur and not be detected by such controls.

As part of our audit of the Commonwealth's basic financial statements, we also performed tests of the Finance and Administration Cabinet's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. The results of those tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*.



Robbie Rudolph, Secretary
Finance and Administration Cabinet
(Continued)

Some findings are Other Matters that we have included in this letter to communicate with management in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*.

Included in this letter are the following:

- ◆ Acronym List
- ◆ Findings and Recommendations (Reportable Conditions and Other Matters)
- ◆ Summary Schedule of Prior Year Audit Findings

We have issued our Statewide Single Audit of the Commonwealth of Kentucky that contains Finance and Administration Cabinet's findings, as well as those of other agencies of the Commonwealth. This report can be viewed on our website at www.auditor.ky.gov.

This letter is intended solely for the information and use of management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Crit Luallen', with a stylized, cursive script.

Crit Luallen
Auditor of Public Accounts

February 28, 2005



CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Robbie Rudolph, Secretary
Finance and Administration Cabinet

MANAGEMENT LETTER

Pursuant to Kentucky Revised Statute (KRS) 43.090 (1), which states, "[i]mmediately upon completion of each audit and investigation, except those provided for in KRS 43.070, the Auditor shall prepare a report of his findings and recommendations," we are providing this letter to the Finance and Administration Cabinet to comply with KRS 43.090.

This letter presents the results of the work performed at the Finance and Administration Cabinet, as part of our annual Statewide Single Audit of the Commonwealth of Kentucky.

In planning and performing our audit over compliance with requirements applicable to major federal programs, for the year ended June 30, 2004, we considered the Finance and Administration Cabinet's internal control in order to determine our auditing procedures for the purpose of expressing an opinion on compliance with requirements applicable to each major federal program and to report on internal control over compliance in accordance with Office of Management and Budget (OMB) Circular A-133 and on the Schedule of Expenditure of Federal Awards (SEFA).

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily disclose all matters that might be reportable conditions.

In addition, because of inherent limitations in internal control, errors or fraud may occur and not be detected by such controls.

As part of our audit of the Commonwealth's basic financial statements, we also performed tests of Finance and Administration Cabinet's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. The results of those tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Some findings are Other Matters that we have included in this letter to communicate with management in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*.



Robbie Rudolph, Secretary
Finance and Administration Cabinet
(Continued)

Included in this letter are the following:

- ◆ Acronym List
- ◆ Schedule of Expenditures of Federal Awards
- ◆ Notes to the Schedule of Expenditures of Federal Awards
- ◆ Findings and Recommendations (Other Matters)
- ◆ Summary Schedule of Prior Year Audit Findings

We have issued our Statewide Single Audit of the Commonwealth of Kentucky that contains Finance and Administration Cabinet's findings, as well as those of other agencies of the Commonwealth. This report can be viewed on our website at www.auditor.ky.gov.

This letter is intended solely for the information and use of management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen", with a long horizontal flourish extending to the right.

Crit Luallen
Auditor of Public Accounts

February 28, 2005

LIST OF ABBREVIATIONS/ACRONYMS

AIL	Agency Implementation Lead
AOC	Administrative Office of the Courts
CAFR	Comprehensive Annual Financial Report
CAMRA	Complete Asset Management Reporting and Accounting
CFDA	Catalog of Federal Domestic Assistance
CFR	Code of Federal Regulations
CIO	Office of the Chief Information Officer
CMIA	Cash Management Improvement Act
Commonwealth	Commonwealth of Kentucky
COT	Commonwealth Office of Technology (Formally known as GOT)
CWD	Cabinet for Workforce Development
DBA	Database Administrators
DHHS	Department of Health and Human Services
FAC	Finance and Administration Cabinet
FAS	Financial Analysis System
Finance	Finance and Administration Cabinet
FY	Fiscal Year
GASB	Governmental Accounting Standards Board
GOT	Governor's Office for Technology (Currently known as COT)
ID	Identification
IT	Information Technology
JVB	Journal Voucher Correction
JVL	Journal Voucher Master Line Offset
KRS	Kentucky Revised Statute
MARS	Management Administrative Reporting System
MRDB	Management Reporting Database
N/A	Not Applicable
OFM	Office of Financial Management
OMB	Office of Management and Budget
OTS	Office of Technology Service
PBU	Program Budget Unit
PCO	Production Cut Over
PCR	Program Change Request
PD	Procurement Desktop
Q&A	Question and Answer
SAS	Statistical Analysis System
SEFA	Schedule of Expenditures of Federal Awards
SWCAP	Statewide Cost Allocation Plan
US	United States

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

CFDA #	Program Title	State Organizations	Expenditures Cash	Noncash	Provided to Subrecipient
FINANCE AND ADMINISTRATION CABINET					
U.S. Appalachian Regional Commission					
Direct Program:					
23.011	State Research, Technical Assistance, and Demonstration Projects		\$ 103,960	\$	\$ 103,960
U.S. General Services Administration					
Direct Program:					
39.003	Donation of Federal Surplus Personal Property (Note 3)			627,599	
U.S. Department of Health and Human Services					
Direct Program:					
93.585	Empowerment Zones Program		999,009		999,009
U.S. Department of Treasury					
Direct Program:					
21.NA(2)	Job Growth Tax Relief Reconciliation Act (Note 2)		68,720,606		
TOTAL FINANCE AND ADMINISTRATION CABINET			\$69,823,575	\$627,599	\$ 1,102,969

NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

Note 1 - Purpose of the Schedule and Significant Accounting Policies

Basis of Presentation - OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, requires a Schedule of Expenditures of Federal Awards showing each federal financial assistance program as identified in the *Catalog of Federal Domestic Assistance*. The accompanying schedule includes all federal grant activity for the Finance and Administration Cabinet, except those programs administered by state universities, and is presented primarily on the basis of cash disbursements as modified by the application of KRS 45.229. Consequently, certain expenditures are recorded in the accounts only when cash is disbursed. The Commonwealth elected to exclude state universities from the statewide single audit, except as part of the audit of the basic financial statements.

KRS 45.229 provides that the Finance and Administration Cabinet may, “for a period of thirty (30) days after the close of any fiscal year, draw warrants against the available balances of appropriations made for that fiscal year, for the payment of expenditures incurred during that year or in fulfillment of contracts properly made during the year, but for no other purpose.” However, there is an exception to the application of KRS 45.229 in that regular payroll expenses incurred during the last pay period of the fiscal year are charged to the next year.

The basic financial statements of the Commonwealth are presented on the modified accrual basis of accounting for the governmental fund financial statements and the accrual basis of accounting for the government-wide, proprietary fund, and fiduciary fund financial statements. Therefore, the schedule may not be directly traceable to the basic financial statements in all cases.

The accompanying Schedule includes cash and non-cash federal financial assistance programs.

Inter-Agency Activity - Certain transactions relating to federal financial assistance may appear in the records of more than one (1) state agency. To avoid the overstatement of federal expenditures, the following policies were adopted for the presentation of the schedule:

- (a) Federal moneys may be received by a state agency and passed through to another state agency where the moneys are expended. Except for pass-throughs to state universities as discussed below, this inter-agency transfer activity is reported by the agency expending the moneys.

State agencies that pass federal funds to state universities report those amounts as expenditures.

- (b) Federal moneys received by a state agency and used to purchase goods or services from another state agency are reported in the schedule as an expenditure by the purchasing agency only.

NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

Note 2 - Type A Programs

Type A programs for the Commonwealth mean any program for which total expenditures of federal awards exceeded \$20 million for FY 04. The Finance and Administration Cabinet had one cash program that met the Type A program definition for FY 04.

The Type A program was:

CFDA #	Program Title	Expenditures
21.NA(2)	Job Growth Tax Relief Reconciliation Act	\$68,720,606

Note 3 – Noncash Expenditure Programs

FAC's noncash program description of the method/basis of valuation follows:

<i>CFDA #</i>	<i>Program Title</i>	<i>Amount</i>	<i>Method/Basis of Valuation</i>
39.003	Donation of Federal Surplus Personal Property	\$627,599	23.3% of federal acquisition cost (\$2,693,561).

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-1: The Finance And Administration Cabinet Should Develop And Implement A Formal Policy To Govern Security Of The Management Administrative And Reporting System Interface Files**

As was noted during the previous year, the Finance and Administration Cabinet (FAC) has not developed or implemented a formal policy concerning security governing MARS Interface Files. Specifically, these procedures should cover the segregation of duties between development of checkwriter datasets and request for processing the datasets to create payments through MARS. Our review revealed 21 users with update access to one or more of 26 specific checkwriter files also had authorization to request these files be processed through Finance.

Allowing users the ability to update checkwriter files and authorize their processing increases the likelihood of unauthorized processing of checkwriter payments, and may compromise the integrity of data processed through MARS.

Formal policies provide a security framework to educate management and users of their security responsibilities. Consistent application of formalized security policy and procedures provides continuity for implementation and sets the tone of management concern for strong system security. To help ensure strong security and the integrity of checkwriter files, it is necessary to develop and implement a formal policy identifying management and user responsibilities concerning MARS checkwriter files. Further, the level of system access granted to users should be restricted to only areas necessary for an employee to perform assigned job duties. It is ultimately the responsibility of FAC to ensure that access to MARS interface files is reasonable.

Recommendation

We recommend that the Finance and Administration Cabinet develop and implement a documented formal policy to govern the security surrounding MARS interface files. This effort should include standardizing procedures to be implemented on a regular basis. We further recommend these procedures include steps to provide for a higher level of confidence in proper segregation of duties concerning update and processing of checkwriter files.

FINANCIAL STATEMENT FINDINGS

***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance***

FINDING 04-FAC-1: The Finance And Administration Cabinet Should Develop And Implement A Formal Policy To Govern Security Of The Management Administrative And Reporting System Interface Files (Continued)

Management Response and Corrective Action Plan

The Office of the Controller will develop and implement a formal policy governing the security access pertaining to checkwriter datasets. This policy will cover the segregation of duties in agencies between submission of checkwriter datasets and the request for processing the datasets to create payments through MARS.

The Office of the Controller will monitor users with “update” access to submit the datasets and confirm they are not authorized to submit the authorization request (E-mail), as well.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-2: The Office Of Financial Management Should Implement Procedures To Ensure The Data Provided For The Year-End Investment Income Accrual Is Accurate And Complete**

Good internal controls dictate that records be properly maintained and that information provided to other departments for accounting and financial reporting purposes be reviewed for accuracy and completeness.

During our review of the FY 04 investment income accrual, we noticed discrepancies between the income and accrued earnings reported in the June month-end file used for the year-end accrual and the income and accrued earnings for June that was provided to us earlier for a different section of the audit. Upon further investigation, it was discovered that the file sent to Finance for the year-end accrual was not the final year-end file for June 2004 but was an incorrect, earlier version of the month-end file.

The investment income receivable in the original file was \$26,792,266. The actual investment income receivable, however, was \$6,785,215. By sending Finance the wrong file, the year-end investment income receivable was overstated by \$20,007,051. After allocating this balance among the investment pool participants, it would have come very close in materially misstating the revenues and investment income receivable for the Capital Projects Fund.

Recommendation

Prior to sending Finance the file for the year-end investment income accrual, the Portfolio Manager should review and approve the file to ensure that it is correct. Although it is beneficial to maintain multiple copies of the Month-End files to provide a trail and supporting documentation for changes made between the initial file and the final file, final versions of the Month-End file should be kept separate from the earlier versions in the Library.

Management Response and Corrective Action Plan

We agree that we should have the final program in a separate file from the preliminary programs. The Office of Financial Management is currently working on a new program that will eliminate the need for multiple month end files. It is anticipated the new program will be in production or running parallel by July 1, 2005. Until the new programs are in production, OFM agrees to maintain preliminary copies of the month end files in a separate location from the final month end. In addition, OFM agrees to have the Accounting Supervisor review the year-end accrual information for accuracy/completeness prior to it being sent to Finance for inclusion in fiscal year end reporting.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-3: The Finance And Administration Cabinet Should Ensure All
Agencies Conduct Accurate And Timely Fixed Asset Inventory Counts**

We observed fixed assets inventory counts at several agencies including Administrative Office of the Courts (AOC), Dept of Parks, and Cabinet for Workforce Development (CWD). While the physical inventory count procedures were improved over last year, the Department of Parks still had deficiencies using the results of the inventory count to correct inventory records in MARS. At four of the fourteen parks we audited, we noted that the results of the inventory counts were not reflected in MARS. The Administrative Office of the Courts had a significant delay in providing auditors and Finance and Administration Cabinet (FAC) with a corrected copy of the inventory record, which hindered the completion of audit work. While the inventory counts were conducted in May 2004, the corrected inventory report was not received until October 2004. The physical inventory procedures were not satisfactory at either of the two CWD locations that auditors attended and did not follow FAC procedures. The inventory-taker ignored assets that were missing property tags. We also noted that several tagged items were missing from the MARS report. The inventory-taker speculated that these items were purchased and tagged, but not entered into the MARS system. One asset still in use was recorded in MARS as "surplus." Further, the results of the inventory count were not used to correct inventory records in MARS.

Good internal controls dictate that a consistent set of procedures be followed when conducting a physical inventory count. This includes applying the results of the inventory count to correct fixed assets inventory records in MARS. Since FAC procedures were not followed, FAC cannot be certain that the fixed asset records used to compile the information for the Comprehensive Annual Financial Report are correctly stated.

KRS 45.313 states "Each budget unit shall maintain a current inventory of equipment having an original cost of five hundred dollars (\$500) or more. The inventory shall be available for examination by the Finance and Administration Cabinet at all times."

The Finance and Administration Cabinet, Division of Statewide Accounting Services requires an annual physical inventory of fixed assets by all state agencies. FAC provides a Physical Inventory Procedures Manual for conducting the annual physical inventory. This manual provides details of how to conduct the fixed assets inventory count.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-3: The Finance And Administration Cabinet Should Ensure All
Agencies Conduct Accurate And Timely Fixed Asset Inventory Counts (Continued)**

Recommendation

We recommend that FAC require agencies to conduct an annual inventory count of fixed assets following the policies and procedures outlined in the Finance and Administration Cabinet's Physical Inventory Procedures Manual. This would include using the 5003 Fixed Assets report to record the results of the inventory observation; searching for and adding unrecorded fixed assets; verifying and correcting the tag number, description, location, serial number, agency, organization and asset type for each asset; and making every effort to locate missing items. This would also include making appropriate, timely changes to the MARS inventory system to reflect the results of the physical inventory count and submitting the corrected 5003 report timely.

Management Response and Corrective Action Plan

We concur with the audit finding. Agencies have been reminded to follow Statewide Accounting Services procedures for physical inventory observations. Additionally, agencies have been made aware of the weaknesses noted by the Auditors of Public Accounts and supplied a web link to the procedure document.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 04-FAC-4: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System

During the audit of the controls over the Commonwealth's Cash and Investments System, it was discovered that the Office of Financial Management (OFM) has a program modification process in place; however, this process had not been formalized in standards or procedure statements specific to the agency. Further, as has been reported for the last two years, although agency personnel are aware of the program modification process, it is not being consistently applied to new programs development and changes to existing programs.

To help standardize the program modification process, OFM has developed a program modification request form called a Program Change Request (PCR). Among the steps associated with this form, approvals are required from various members of agency personnel to ensure that the requested change is necessary, the proposed coding change is reasonable, and the altered program code has been sufficiently tested for accuracy and applicability to the requested change. Once all of these approvals have been placed on the PCR, then a final approval to move the change into production must be applied.

The review of documentation maintained in support of the program modification process revealed that there was no central repository or logging of PCR requests that are within this program modification process. The auditor found 14 complete PCR requests and 2 incomplete PCR requests for changes that had been promoted to production within the possession of one or more of these individuals: the programmer, the internal auditor, and the librarian for the production environment. Also, after asking about new program development, there was an additional complete PCR form presented to the auditor, which had not been in the possession of any of these individuals during the testing phase.

During testing for FY 04, the auditor identified 1,042 instances where changes were made within 36 programs. Of these changes, there were 254 instances, or 24.4 percent, that were not supported by a PCR or considered a 'general maintenance' change. Additionally, there were two instances of changes attributed to a PCR that did not go through the entire PCR process and another two instances associated with only an e-mail request.

As discussed with the agency during the prior year audit, a 'general maintenance' PCR may be used for routine program changes, which can include changes to the cycle number, fiscal year, date, number of days in the month, and file name changes where the file name contains a date or month that corresponds to the date/month being processed. There were 628 'general maintenance' changes identified within the 1,042 instances of changes for FY 04, or 60.3 percent, that the auditor would consider meeting the requirements of a general maintenance program change.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-4: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System (Continued)**

Only one of these changes was supported by an e-mail requesting the change. The remaining 627 changes were not supported by an e-mail or other communication of the issues to be resolved, a code comparison identifying all changes made to the program, or proper approval from a person other than the programmer to move the changes into production.

A review of the PCR forms and supporting documentation revealed that there is no listing consistently developed that specifically discusses or shows the changes that were made in the program code. Of the 15 complete PCR forms for FY 04, the auditor found only 3 forms, or 20.0 percent, whose supporting documentation included a code comparison between the original code and the revised code. For the remaining requests, the auditor was only able to trace changes based on the descriptions on the form of the proposed changes.

It was also discovered during this review of the complete PCR forms that there were a significant number of changes being placed into the production environment before receiving the final approval for implementation. There were a total of 12 PCR forms that were found in exception, or 80.0 percent of all complete PCR forms. Two forms were for changes that were moved to production before receiving the final approval for implementation, while another ten forms were for changes that were moved to production even before testing was reviewed and, of course, prior to any final approval for implementation. The most blatant example of this situation occurred when a program was placed in production nearly a month prior to the approval to proceed with changes and over seven months prior to the approval for implementation. This particular request concerned an initiative by OFM to modify existing programs and develop any necessary new programs to ensure that the cash within the portfolio accounts could be matched between the Commonwealth's financial system and the Cash & Investments System.

During discussions with the librarian over the production environment, it was discovered that due to a lack of documentation required, program changes could be placed into production without proper approval for implementation. Agency personnel had informed the librarian that the only requirement for uploading programs into the production environment was an e-mail message from the programmer. Further, the librarian does not participate in the completion of the PCR form, although there is a section on the form that is to be filled out by the person that has implemented the change to production.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-4: The Finance And Administration Cabinet Should Formalize And Consistently Apply The Program Modification Process For The Commonwealth's Cash And Investments System (Continued)**

Without a formalized program modification process and monitoring of the compliance with the process, the agency is at risk that procedures that are deemed vital to the process will be overlooked. For example, disregarding the procedure established to review supporting documentation for evidence that a change has been tested and approved for promotion to production could circumvent the control in place that only allows the librarian to have write access to the production environment. This increases the likelihood that unauthorized or inappropriate program changes could be placed into production.

The program modification process should be formalized, distributed, and understood by all applicable agency personnel. This process should be consistently applied to all code changes to existing programs and the development of new programs. Within the agency's response to FY 03 comments, they showed their agreement with this criterion by stating, "All new programs and modifications to programs must have a program change form filled out."

To ensure that all program modifications are monitored and thoroughly documented, a procedure should be established for logging all program modification requests and a standard should be developed to define the supporting documentation to be maintained with the PCR form.

Recommendation

We recommend that OFM formalize, implement, and consistently apply control procedures over the program modification process. Specifically, the agency should, at a minimum:

- Develop a formal procedure manual for the program modification process. This manual should include the procedures to adequately document program specifications and understanding of program objectives, to specifically identify changes in code by developing a code comparison listing between the original code and the revised code, to properly complete the PCR form, to adequately test proposed program code changes, and to verify that all approvals are in place for the program code change before implementation to the production environment. If emergency situations are anticipated that might require this process to be accelerated, then that should be taken into consideration and an alternative process developed that properly applies compensating controls over that accelerated process.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-4: The Finance And Administration Cabinet Should Formalize
And Consistently Apply The Program Modification Process For The
Commonwealth's Cash And Investments System (Continued)**

Recommendation

- Process all new programs and modifications to existing programs through the established program modification process as documented in the formal procedure manual.
- Ensure all changes comply with established program modification procedural requirements. Requirements should include that all changes are properly reviewed for accuracy by an individual other than the programmer and that proper approvals are documented authorizing implementation of the change into production before the librarian moves the change to the production environment. After implementation of changes, the librarian should sign and date the PCR form to affirm that this process has been completed.
- Ensure, for those changes that relate to a 'general maintenance' PCR form, that the programmer provides supporting documentation for the request of the program changes, inclusive of an e-mail or other communication of the issues to be resolved, identification of the specific program code that was changed to satisfy the request, and approval from a person other than the programmer to move the changes into production. All personnel involved with authorizations on the PCR form should be made aware of the responsibilities they are assuming with their authorizations on these forms.
- Establish a logging feature within the program modification process. This log should include the name of the originator, origination date, brief description of problem, programs affected, completion date, and implementation date.
- Establish a centralized location for maintaining all complete PCR forms.

We are aware that the agency has begun the process to replace the current Cash and Investments System; however, we believe that the recommendations proposed are universal enough to relate easily with the new system development. It is the historical precedent within OFM to require continuous program changes that has caused the auditors to strongly advocate the agency formalize and consistently apply appropriate program change control procedures.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-4: The Finance And Administration Cabinet Should Formalize
And Consistently Apply The Program Modification Process For The
Commonwealth's Cash And Investments System (Continued)**

Management Response and Corrective Action Plan

The Office of Financial Management agrees the Program Change Request is not being completed as required. We are currently in the process of writing a new program. This will eliminate the need to make any updates to the old SAS program. Once the new program is in place, all program files will be placed in the Library. Any change to the file will require approval of the Accounting/IT supervisor. The Librarian will be instructed to move the files after the supervisor has approved. Once the new program is complete, a formalized process for program changes will be completed and implemented. The new month end program will run through LanBatch, therefore the program changes will not be implemented until approved by the supervisor and moved to the Library.

We will establish a logging procedure for program change requests and have one documentation file that will have all signed reports.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-5: The Finance And Administration Cabinet Should Strengthen Logical Security Procedures Surrounding The Complete Assets Management Reporting and Accounting System**

During the FY 04 audit of the Commonwealth's Cash and Investments System, the Office of Financial Management (OFM) did not properly secure the critical financial data associated with the distribution of earnings from investments. Further, OFM has not developed or implemented a formalized security policy that identifies management and user responsibilities concerning IT security surrounding the Cash and Investments System.

By moving all production programs into a secured file directory that is restricted to the Librarian and the Commonwealth Office of Technology administrators, OFM has increased the security over the system programs. However, the auditors found a significant number of files, including production data files, being used within current system programs that reside in another directory that is not as strictly secured. Also within this directory is the staging libraries used by the programmer to hold programs waiting to be moved to production. All OFM staff currently has 'Change' access to these files, which would allow them to read, add, alter, or delete these files.

Without strong, formalized, logical security controls, the opportunity increases for unauthorized modification to production files as well as the likelihood of errors or losses occurring from incorrect use of data and other resources.

Formalized security policies set the tone of management concern for strong system security and provide a security framework used to educate management and users on their responsibilities. Further, access to directories that house programs and critical financial data should be restricted to only necessary employees. System security should be administered in such a way as to ensure proper segregation of duties. Granting users system access that would allow the ability to alter or delete programs or financial data prior to or subsequent to processing increases the risk of financial misstatements or fraudulent reporting.

Recommendation

We recommend that OFM develop and implement a formalized security policy that standardizes security responsibilities for all employees and ensures critical programs and data are properly secured. All Cash and Investment System related programs should be reviewed to ensure that financial data files being used or created are being housed in a properly secured directory. Further, access to the program staging library should be properly restricted.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 04-FAC-5: The Finance And Administration Cabinet Should Strengthen
Logical Security Procedures Surrounding The Complete Assets Management
Reporting and Accounting System (Continued)**

Management Response and Corrective Action Plan

A formalized policy will be written and implemented during FY2006. We are in the process of writing a new program and the security policy will reflect that program. Beginning with FY2006, all program files will be maintained in the Library. The only time the files will be moved/changed is when a program change request has been submitted and approved. After the programmer makes the change, the files will be placed in a secure folder. The folder will have security to allow only the supervisor to have write access. Once the files have been reviewed and approved by the supervisor the Librarian will be contacted to move the files into the Library.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-6: The Finance And Administration Cabinet Should Ensure Proper Classification And Categorization Of Investments In The Cash And Investment Note

The Finance and Administration Cabinet (FAC) Comprehensive Annual Financial Reporting (CAFR) team prepares the Cash and Investments note (Note 5). The CAFR team uses confirmations and independent audit reports to compile summary sheets for each entity that is a part of the Commonwealth. The summary sheets for each state government entity provide cash and investments classifications and categorizations. In reviewing supporting information for each summary sheet, problems were noted in the classification and categorization of cash and investments.

Classification

In reviewing the summary sheets prepared by FAC, we noted some classification errors in fiscal years 2001 through 2003. This year, of the ten (10) summary sheets examined, we found five (5) had securities incorrectly classified by type of investment. For example, common stocks and corporate bonds were classified as annuities for the University of Kentucky.

Categorization

In reviewing the summary sheets prepared by FAC, we noted some categorization errors in fiscal years 2002 and 2003. This year, of the ten (10) summary sheets examined, we found three (3) improperly categorized investments at fair value rather than carrying value when the information was available.

According to paragraph 68 of Statement No. 3 of the Governmental Accounting Standards Board, “the carrying amount and market value of investments (including repurchase agreements) as of the balance sheet date should be disclosed in total and for each type of investment. The disclosure of carrying amounts by type of investment should be classified in these three categories of credit risk:

- a. Insured (see paragraph 25) or registered, or securities held by the entity or its agent in the entity's name
- b. Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the entity's name
- c. Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount of any repurchase agreement that exceeds the market value of the underlying securities.)”

According to the Guide to Implementation of GASB Statement 3, Q&A number 93, “investments should be classified in the categories of credit risk based on carrying amount.”

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-6: The Finance And Administration Cabinet Should Ensure Proper Classification And Categorization Of Investments In The Cash And Investment Note (Continued)**

Recommendation**Classification**

We recommend FAC ensure established procedures are followed to provide assurance that investments agree by classification to independent audit reports and other supporting documentation.

Categorization

We recommend steps be taken to ensure that investments be categorized based on carrying value when the information is available.

Management Response and Corrective Action Plan

We agree and will make the appropriate changes to the closing package to better facilitate the gathering of information that is reported by discretely presented component units. We will also verify that investments are reported at carrying value when the information is available to us. Our general instructions to component units will stress that audited statements and note disclosures must be in compliance with all GASB standards.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-7: The Office Of Financial Management Should Review Transactions To Ensure That Revenue Is Recognized Properly In MARS**

Investment income should only be recognized in MARS when securities are sold, interest payments are received, to accrue interest at year-end, or to adjust the investment portfolios to fair value at year-end.

During FY 04, \$9.1 million of investment income was recognized on JVL00007409 and JVL00007411 as a result of transferring securities between OFM's investment portfolios. Although the securities were moved between pools (and not sold) revenue was recorded in the accounting system. We understand that OFM personnel decided to report the transfer as income so that earnings would be distributed appropriately to accounts for which the earnings were due, however, revenue should only be recognized in MARS upon the sale of securities, receipt of interest payment, and the year-end accrual and adjustment of the investment portfolios to fair value.

When revenue is recognized in the accounting system and a transaction has not occurred, this could result in a material misstatement in the financial statements.

Recommendation

If securities need to be transferred among investment portfolios, we recommend that OFM either 1) sell the securities and then repurchase them in the new portfolio or 2) make an adjustment in the month-end earnings allocation and cash distribution process so that earnings would be distributed to the appropriate accounts without having to recognize revenue in MARS.

Management's Response and Corrective Action Plan

The Office of Financial Management understands the position of the audit staff. The staff of OFM will discuss the proper handling of these transfers. It is anticipated we will either a) establish an accrual account that will hold the accrued interest on the securities until actual interest is received or b) enter an adjustment for the amount of earnings that belong to each pool. Both options would allow the proper pool to receive the earnings for their share of the interest.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-8: The Office Of Financial Management Should Ensure That The Ending Accrued Earnings Is Updated In The Month-End File When Adjustments Are Made To An Account's Cash Distribution

Good internal controls dictate that when an adjustment is made to one month's cash distribution in the month-end file, the ending accrued earnings should be updated to the reflect this change.

During our FY 04 testing of the cash distribution process in March's month-end file, an adjustment was made to the cash distribution for the post-to account 7200-C35-XX-XXX-YY97. Although the month-end file reported a \$3,902.40 cash distribution with \$0.00 ending accrued earnings, cash actually was not distributed to this account on the month-end JVB. Since cash wasn't distributed, the beginning accrued earnings for April should have been adjusted from \$0.00 to \$3,902.40, which failed to occur.

The post-to account 7200-C35-XX-XXX-YY97 did not receive the cash distribution it was entitled to for March 2004. In addition, since the file reported a cash distribution (when it actually wasn't made) the ending accrued earnings for March and the beginning accrued earnings for April were understated, which resulted in the account losing the \$3,902.40 of accrued interest to which it was entitled.

When adjustments are made to the cash distribution and ending accrued earnings without preparing final report of the adjusted ending accrued earnings and when these ending balances do not equal the next month's beginning balances, there is an increased chance that an error will occur in the distribution process that will remain undetected.

Recommendation

Procedures should be developed so that when an adjustment is made to an account's stated cash distribution, the adjustment will also impact the account's ending accrued earnings accordingly. To facilitate this, we recommend that after the month-end file has been run and the cash has been allocated on the monthly JVB, a final month-end report should be prepared to reflect changes made between the month-end file's cash distribution and the JVB. In addition, controls should be built into the programming so that the beginning accrued earnings for the subsequent month equal the prior month's ending accrued earnings.

Management Response and Corrective Action Plan

The Office of Financial Management began performing a monthly reconciliation in July 2004. The reconciliation verifies that Mars and Camra reconcile on a Mark to Market basis. In addition, the reconciliation is used to verify Ending Accrued equals the Beginning Accrued for the following month.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-9: The Finance And Administration Cabinet Should Establish And Apply A Security Policy Concerning Local Workstations

During the review of password settings within the domain maintained by Finance, the auditor found 32 machines that provided password policies. Only two of these machines had established policies that adhered to the Finance and Commonwealth Office of Technology (COT) policies. The remaining 30 machines had the default settings from the original setup which do not agree with the standards set by Finance and COT. Since these machines are considered local workstations, the agency is not holding them to the same standards as set forth in the Finance and COT policies. However, the agency has not developed a policy or procedure statement to cover the establishing of password policies on local workstations.

Further, the auditor found on 28 of these machines that the local administrator accounts had passwords ranging in age from 66 days to 430 days old, which is significantly older than the password policy of 42 days established for the machine.

If password policies are not strong and consistently applied, the agency could potentially be vulnerable to unauthorized access or disruption of service caused by an intruder.

Passwords are a significant feature to guard against unauthorized system access. The failure to follow adequate policy standards when establishing a system password could ultimately compromise the entire network. The purpose of a password policy is to establish a standard to create strong passwords, to protect those passwords, and to ensure passwords are changed within a specified time period. Further, since the local administrator cannot be locked out, the machine could be vulnerable if a potential intruder attempted to gain access by guessing the administrator password through a brute force attack. To assist in the security of a network, administrator account passwords should be sufficiently complex and should be changed in a timely fashion according to the established policy.

Recommendation

We recommend that Finance establish a policy statement concerning the overall security for local workstations. Specifically this policy should establish the password settings for local workstations and a schedule for changing the local machine administrator account passwords to adhere to the password policy. Finally, we recommend once this policy is established, Finance implement procedures to ensure compliance.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-9: The Finance And Administration Cabinet Should Establish And Apply A Security Policy Concerning Local Workstations (Continued)****Management Response and Corrective Action Plan**

The Finance and Administration Cabinet current Domain Password Policy is as follows:

<i>Maximum Age:</i>	<i>30 day</i>
<i>Minimum Age:</i>	<i>Immediate - None</i>
<i>Minimum Length:</i>	<i>8 characters (instead of the recommended 6 characters)</i>
<i>Lockout Threshold:</i>	<i>5 attempts</i>
<i>Lockout Duration:</i>	<i>Forever</i>
<i>Lockout Reset:</i>	<i>1440 Minutes</i>
<i>Password History</i>	<i>12</i>

Actions to be taken:

Set local account policies to match Domain Policies under the COT Policy Number: CIO-072. The Finance Cabinet has merged with COT and Revenue and should adopt the enterprise policy on servers and workstations.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-10: The Finance And Administration Cabinet Should Develop Formal Procedures For System Assurance Efforts Concerning The Financial Analysis System**

As noted in the previous three audits, there are no formal procedures in place for assuring the completeness or reliability of FAS data. FAS is a client/server reporting system that is accessed via the Internet and permits system users to analyze Management Administrative Reporting System (MARS) financial data with minimal effort and expertise. The primary source of data for this system is from the Management Reporting Database (MRDB), a module of MARS. Data is also pulled from the Commonwealth's payroll system and the Procurement Desktop module of MARS.

Although OTS is aware that there are specific problems with the importing of data from these other systems and the existence of static tables in the database that are not being updated nightly, they assume that the data is accurate. This assumption is based on the fact that OTS is depending on system users to notify them when system errors or inaccurate data occur. OTS has not received any user complaints regarding data accuracy; therefore, no formal reviews have been performed.

The FAS data is completely rebuilt each night and a nightly cycle report is generated the following morning for review. This nightly cycle report lists the filename, file size and date of file creation. This report is manually examined only to determine that information appears reasonable. If for some reason the data does not appear complete, the next nightly cycle is expected to correct any problems. No other formal procedures are performed to assure FAS data and/or system totals are accurately downloaded.

Without formalized system assurance procedures, there is no assurance that the data integrity within FAS has not been compromised. As a result, users cannot truly rely on the accuracy of the data within FAS.

Formalized system assurance procedures illustrate management's concern for strong data integrity within the system. Ultimately, the Office of Technology Services (OTS) is responsible for the support of the Financial Analysis System (FAS) and should ensure the accuracy of data by implementing formalized system assurance procedures for FAS. This process should include report comparisons to the Management Reporting Database (MRDB) as well as descriptions of the OTS employee's error resolution processes. Further, reconciliations should be performed daily to ensure that FAS reported amounts agree with reports from MRDB.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-10: The Finance And Administration Cabinet Should Develop Formal Procedures For System Assurance Efforts Concerning The Financial Analysis System (Continued)**

Recommendation

We recommend that the Finance and Administration Cabinet develop detailed written procedures to be followed for the creation and review of the daily and monthly system assurance reports between the FAS and the MRDB and for the correction of errors discovered through review of these reports. Further, these procedures should be distributed to all employees that are involved with the FAS system assurance task. If Finance continues to refuse to comply with these recommended procedures then we recommend they notify all agencies of the risks faced when relying on FAS data.

Management Response and Corrective Action Plan

Finance is both aware and concerned about the system assurance deficiencies that exist in the current FAS application. FAS is scheduled to be retired soon as its reporting capabilities will be replaced by the MARS upgrade to Advantage 3.

Modifications to the existing FAS system:

FAS is a legacy system and its non-standard architecture makes it difficult to modify. The COT development team recommends that updates to the system should be kept to a minimum.

Concerning the accuracy of FAS data:

Various agencies have been using FAS for over 10 years as a financial estimation and forecasting tool. Agencies that chose to use FAS were informed that the application could be useful for providing approximations but were instructed to rely on their internal budget office for accurate financial data.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-11: The Finance And Administration Cabinet Should Work in Conjunction With The Governor's Office Of Technology To Strengthen Procedures Surrounding Procurement Desktop Audit Logging**

Although the Finance and Administration Cabinet (FAC) in conjunction with the Commonwealth Office of Technology (COT) have implemented logging and audit features within Procurement Desktop (PD), our audit revealed procedures surrounding unsuccessful login reviews should be strengthened and consistently applied.

We noted that unsuccessful login attempts are being captured, reviewed daily, and archived weekly. However, this review is limited to user ids of database administrators, system ids, and users with rights to update PD data from outside the application. This review does not include those users with update privileges within the PD application. Further, this review of unsuccessful login attempts is not formally documented. Test procedures revealed that between July 2003 and February 2004 there were 26,181 unsuccessful login attempts associated with usernames that had update privileges within the PD application. Examination of these attempts revealed that 1,555, or approximately 6 percent, appeared suspicious in nature.

A single individual reviews the daily listing of unsuccessful login attempts. This individual is one of the PD database administrators from COT who has full access rights to the PD database and audit logs. Instances were noted during the period where this individual attempted unsuccessfully to log into Oracle three times with usernames belonging to the two other PD database administrators. An additional four instances were noted where another database administrator attempted to log into the Oracle database using two IDs that were not assigned to the administrator, one of which had update rights to the PD application. Though these types of login attempts should have been included in the daily review, there was no documentation supporting the reason for these actions or whether follow-up action was taken by the employee's supervisor due to these incidents. The auditee could not provide adequate explanation for these incidents.

Finally, the unsuccessful login attempts for the month of September 2003 were not available for the auditor's review.

Without adequate PD audit logging procedures, the data integrity within PD is at risk. If an unauthorized person gained inappropriate access to the system and was not discovered by the agency, the accuracy of the data residing in PD could be questioned.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-11: The Finance And Administration Cabinet Should Work in Conjunction With The Governor's Office Of Technology To Strengthen Procedures Surrounding Procurement Desktop Audit Logging (Continued)

Transaction logging and auditing helps to ensure that only authorized access has taken place and that changes to the system are in accordance with the established security policy. Implementation of adequate intrusion detection and incident handling procedures by the data owner is essential to ensure a secure system. System access logging and monitoring is a critical component of an adequate intrusion detection process. Access to system logs should be secured to prevent unauthorized modifications or deletions of logged security incidents.

Recommendation

We recommend the Finance and Administration Cabinet in conjunction with COT:

- Expand the review procedures concerning unsuccessful login attempts to include those users that have update access to PD data through the application.
- Change the access rights to the system logs of unsuccessful access attempts for the PD database administrator to read-only.
- Consider changing the individual performing the review of unsuccessful attempts to someone other than a PD database administrator.
- Ensure reviews of the unsuccessful login attempts are performed on a regular basis and are thoroughly documented. All supporting evidence should be maintained concerning security incidents noted and subsequent actions taken due to these instances.
- Ensure the system logs are consistently maintained in an accessible format for audit review purposes.

Management Response and Corrective Action Plan

We will move the examination of unsuccessful PD login attempts from the COT DBAs to the Division of Statewide Accounting and expand the review to include all unsuccessful login attempts from the application. The tables will be read only to the Division of Statewide accounting, but obviously in order to populate the tables the DBAs will have to have write access.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-12: The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System

As noted in the previous three audits, the Finance and Administration Cabinet (Finance) does not have formal procedures in place to ensure the authorization of program modifications to the Financial Analysis System (FAS).

Since the FY 03 audit, Finance has developed and maintained a log in order to keep track of system changes. However, no formal procedures have been developed or implemented. Although this log was maintained, modification requests were not being approved or monitored by management. All program modifications were made without formal documentation by the system developer. This individual is also responsible for testing and placing FAS programs into production.

Without formal program modification policies in place, unauthorized system changes could occur.

Formal program modification procedures are essential to ensure no unauthorized changes are made to system programs and data. Ideally, program change requests should be documented and procedures should be in place to track the progress of requests. Further, program modification procedures should include system-testing efforts to ensure program modifications meets requirements.

The established procedures should consist of adequate testing facilities to ensure that any problems are identified and corrected before they are placed into the production environment, adequate documentation of user acceptance and authorization prior to placing modified programs into production, and adequate segregation of duties between programmer and librarian functions. Programmers should not have ready access to production source code or the ability to move programs into and out of the production environment.

Recommendation

We recommend that FAC develop and distribute specific policies and procedures for program changes to FAS. In addition, personnel should be made aware of and trained on the proper procedures for requesting, authorizing, monitoring, and moving into production any modifications for FAS programs. Documentation of FAS program change requests, request status, and evidence of proper authorization for changes should be maintained as an audit trail.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-12: The Finance And Administration Cabinet Should Consistently Apply Established Program Modification Control Procedures For The Financial Analysis System (Continued)**

Management Response and Corrective Action Plan

The maintenance for the FAS application and its related server infrastructure has been moved to COT. Any migration of FAS code into the production environment is subject to existing COT Production Cut Over (PCO) procedures. These procedures include stringent change control and require separation of duties and security access for developer, librarian, and production personnel.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-13: The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System

During the prior year's audit, security over FAS was decentralized where the Office of Technology Services (OTS) established the FAS security administrators based on information provided through the Agency Implementation Leads (AILs) or their designee. At that time, there were over 1,000 users. During FY 04, the security administration function was centralized. The FAS Security Administrator must now receive an email request from the MARS Security Officer in the respective agency in order to grant system access. The system has also gone through a "clean up" process where users no longer needing access were deleted from the system. As a result, the number of FAS users decreased to 673.

At the time of testing we became aware of the Finance and Administration Cabinet (Finance) plan to compile a list of FAS users within each agency that would be sent for verification once the new organizational structure changes proposed by the governor were official. This process should further reduce the number of FAS users. The requests for a review of FAS users were sent out in July 04.

While improvements have been made to the logical security of FAS, weaknesses still remain. The issues are summarized below:

- Each user password is readily visible in clear text by the security administrator on the security maintenance screen.
- FAS does not force an initial password change for new users nor does the system require password changes on a frequent basis.

Failure to follow established security policy increases the risk of unauthorized access or modification to computer programs and data, destruction of assets, and interruption of services.

Consistent application of established security policies and procedures provides continuity for policy implementation and sets the tone of management concern for a strong system to secure assets and resources. To strengthen security over the Financial Analysis System (FAS), a formal security policy must be established and followed. In addition, formal documentation should be maintained to support authorization to the system and passwords should not be visible in clear text to users or system administrators.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-13: The Finance And Administration Cabinet Should Improve Logical Security Measures Over The Financial Analysis System (Continued)**

Recommendation

We recommend Finance take the following steps to improve the logical security administration function for FAS:

- Shadow, suppress, or encrypt user passwords on the security maintenance screen to prevent unauthorized FAS access. Applicable system password files should also be encrypted.
- Develop a password policy specifically addressing FAS password construction requirements and required periodic password changes similar with other applications housed and maintained by Finance OTS. Since Finance has adopted the UserID and Password Policy issued by the Commonwealth Office of Technology (Policy Number CIO-072), we suggest they apply the same standards to FAS.
- Alter the password requirements to require an initial logon password change.

Management Response and Corrective Action Plan

Item #1 has been addressed with a revision to the FAS software so the password is no longer visible in clear text.

Item #2 was discussed during the above rewrite but was determined to be cost prohibitive do to the delicate nature of this program and its utilization of multiple software packages. Although it does not require a new user password change or frequency change, it does now require a minimum 8 characters with letter, number and a special character so passwords are much harder to 'crack'.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-14: The Finance And Administration Cabinet Should Improve Monthly Reconciliation Procedures

During the FY 04 audit of the Commonwealth's Cash and Investments System, the Office of Financial Management (OFM) did not adequately document reconciliation procedures to show that manual entries made within the program that is used for end of month processing were appropriate and authorized.

The programmer manually enters the payoff and adjustment amounts used for distribution in the End of Month Statistical Analysis System (SAS) program. Payoffs are used in order to distribute the available cash per pool to pay off the zero average cash balance accounts. Adjustments are made within the program to ensure OFM's accrued balances are in agreement with the Complete Asset Management, Reporting, and Accounting (CAMRA) system and the Management Administrative and Reporting System (MARS).

Since the FY 03 audit, there have been improvements made with regards to the number of manual entries being made in the End of Month SAS programs and the documentation on file to support these entries. However, the auditors found that documentation was not being consistently maintained for the monthly reconciliation concerning the amounts being entered into the end of month programs for payoffs and adjustments.

During March and April 2004, the programmer did not enter a payoff amount to be processed within the program even though management authorized payoff amounts for the Bond, Intermediate, Short-Term, Long-Term, and Tran pools. There was no documentation being maintained by the programmer or within the reconciliation file to identify why these amounts were not included in the end of month program. During May and June 2004, again there were no payoffs coded into the program and there was no documentation on file from management that a payoff was not necessary for the months.

Based on a review of the reports produced during monthly processing, the auditor is not questioning the lack of payoff amounts for these months. According to these reports, there were no accounts that needed to be paid off within any of the pools for the months under review. The issue is the lack of documentation for the programmer's actions.

Within the End of Month SAS program for July 2003, the programmer manually entered \$8,000.00 as the payoff for the Bond pool. However, management only authorized a payoff in the amount of \$4,000.00. There is no additional documentation maintained within the reconciliation file of the reason or authorization for this variance in the payoff amount. Since the payoff amounts are taken from the available cash to distribute, this potential overpayment of accounts would not have an effect on the overall cash distributed for July 2003. However, if management did not authorize the additional \$4,000 payoff, then these funds should have been distributed among all active Bond accounts for the period.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-14: The Finance And Administration Cabinet Should Improve Monthly Reconciliation Procedures (Continued)**

Also, during March through May 2004, there were adjustment amounts included in the end of month programs. The amounts used for March and May were documented, but during the testing, the documentation was not located solely within the reconciliation documentation. The April end of month program included three adjustments: (\$935,289.65) to the Bond pool, (\$2,436,506.65) to the Intermediate pool, and (\$3,402.27) to the Short Term pool. These amounts were not equal to the Accrued Interest Adjustment needed for these pools during the month. The difference between the needed adjustment and the actual adjustment coded in the program was not documented.

Reconciliation procedures are performed after the final run of End of Month processing to ensure the payoffs and adjustments provided by management matches those amounts reported by the program for each pool. A review of the monthly reconciliation documentation revealed that procedures were not consistently followed in reconciling figures produced within the SAS reports and there was no documentation to support differences between management designations of payoff and adjustment amounts and those shown as a result of processing.

Without complete and thorough reconciliation procedures, the risk of unauthorized entries to the SAS programs that perform monthly processing is increased. In addition, if payoff and adjustments amounts are not accurately defined in the monthly processing, certain accounts may receive an inappropriate cash distribution.

Reconciliation procedures should ensure manual entries made in the SAS programs are authorized. Sufficient documentation should be maintained within the reconciliation file to show that these manual entries are appropriate.

Recommendation

We recommend that OFM expand on the monthly reconciliation procedures already in place by retaining documentation to show the initial request for payoffs and adjustments. Further, documentation should be kept explaining any differences between this initial request and the final amounts within the End of Month program. The documentation maintained should support the manual entries made by the programmer within the End of Month SAS programs. Finally, OFM should make a determination as to whether any payoff or adjustment amounts are necessary because of the variances noted within this comment.

We are aware that OFM is in the process of developing a new system, which may automate the payoff amount determination. We recommend that this function be developed, if feasible.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-14: The Finance And Administration Cabinet Should Improve Monthly Reconciliation Procedures (Continued)**

Management Response and Corrective Action Plan

For the remainder of FY 2005, the Accounting/IT Section supervisor will be designating the amount to payoff within each pool by writing the request and signing it. The programmer will then enter the payoff amount. After month end is finalized and reviewed, the supervisor will sign off on the month end reports. Beginning with FY2006, we will have an automatic payoff process. The program will calculate 10% of available cash to distribute and allow that amount to be used to payoff closed accounts prior to final distribution to other accounts. This will cut down on the manual entries that are necessary at the current time.

One primary month end file will be maintained with all of the signed documentation and final reports. Starting with February 2005 the primary month end file will be maintained in the supervisor's office.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-15: The Finance And Administration Cabinet Should Improve Segregation Of Duty Controls

Although there have been significant improvements made by the Office of Financial Management (OFM) that have strengthened controls over the system programmer's access to the production environment, as has been noted in the previous two audits, OFM still does not employ proper segregation of duties between the programming and operation functions.

During the FY 03 audit, the programmer was functioning as the computer operator for the Statistical Analysis System (SAS) programs used within the Commonwealth's Cash and Investments System, by submitting production programs for processing on a routine basis. This situation has improved within FY 04, in that a program scheduler called LanBatch has been used to perform daily processing, which is overseen by the system librarian. However, the programmer is still processing the monthly programs within production.

Employing strong segregation of duty controls decreases the opportunity for unauthorized modification to files and programs, and decreases the likelihood of errors or losses occurring because of incorrect use of data, programs, and other resources.

Computer programmers should not have direct access to program source code or be able to directly affect the production environment. The reason for this control is to ensure that the computer programmer does not intentionally or unintentionally introduce unauthorized or malicious source code into the production environment. Smaller organizations that cannot easily segregate programmer duties from computer operator duties should implement compensatory controls to supervise programmer activities to ensure only properly tested and authorized programs are migrated into production.

Recommendation

We recommend that OFM not allow the programmer to process the monthly programs. This function should be performed by another person within the agency or with an automated scheduler that will allow for the necessary flexibility of the timing and repetition of production processing.

Management Response and Corrective Action Plan

Beginning in approximately December 2005, the programs will be included in LanBatch processing. This will result in the programmer no longer having access to the month end programs. Prior to the programs being included in LanBatch, several things need to occur.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-15: The Finance And Administration Cabinet Should Improve Segregation Of Duty Controls (Continued)**

Management Response and Corrective Action Plan

*1) The new program will have to pull from the old program to run July month end,
2) OFM will be upgrading to Access 2003 after the new program is put into production, which will result in parallel processing of Access 2003 and Access 1997 programs for at least two months. Once parallel processing of Access 2003 and Access 1997 has been completed and Access is 2003 is working properly, the new program will be placed in LanBatch.*

The only time the programmer will have access to the programs is to make programming changes, which have been requested and approved on a Program Change Request. In addition, the programmer will then place the new program into a separate file location. The supervisor of the Accounting/IT Group will then review the new program and once approved, the supervisor will instruct the Librarian to move the files to the Library. The programmer will not have access to the program files after they are moved for Supervisor approval.

FEDERAL AWARD FINDINGS AND QUESTIONED COSTS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-FAC-16: The Finance And Administration Cabinet Should Improve Policies And Procedures For The Statewide Cost Allocation Plan**

FAC is required to submit a statewide cost allocation plan (SWCAP) to the Department of Health and Human Services (DHHS) that allows state agencies to claim central service costs under federal awards. We reviewed FAC's instructions for preparing the SWCAP and noted the following control weaknesses:

- The instructions do not sufficiently describe the interrelationship of the various schedules that support the expenditure allocations.
- The instructions do not list the MARS program codes & activities for the central service agencies included in the allocation process.
- The Excel workbook is not reviewed to ensure the formulas are correct; carried forward to the appropriate supporting schedules; and, include the appropriate cell values.

Without adequate instructions and review, FAC cannot be sure that allocated expenditures are correct and in compliance with OMB Circular A-87.

Good internal controls suggest that procedures are sufficient to provide reasonable assurance that the allocation process is accurate and complete.

Recommendation

We recommend FAC improve the SWCAP process by considering the following:

- Include in the instructions a description of the supporting schedules used in the allocation process;
- Provide in the instructions a complete list of codes used in the allocation process; and,
- Review the Excel workbook before submitting the Plan to DHHS.

Management Response and Corrective Action Plan

FAC is currently rewriting the instructions for preparing the SWCAP to ensure that the interrelationship between the various schedules is apparent and easy to understand. The instructions will also describe the activities that are included. We will also include the list of program codes (PBUs) that were used for the most current cost allocation plan. Since PBUs may change from year to year, the list must be reviewed and updated annually.

FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 04-FAC-16: The Finance And Administration Cabinet Should Improve Policies And Procedures For The Statewide Cost Allocation Plan (Continued)

Management Response and Corrective Action Plan

FAC makes every effort to review the workbook to ensure all formulas are correct and carried forward to the appropriate schedules. FAC is diligently working to improve the cost allocation process and ensure that the information presented is understandable and accurate.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Reportable Conditions</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 03	03-FAC-3	The Finance And Administration Cabinet Should Ensure All User Accounts On Its Agency Machines Are Necessary	N/A	0	Resolved during FY 04.
FY 03	03-FAC-4	The Finance And Administration Cabinet Should Secure Listings Of User Names And Associated User IDs For Power Users Of The Management Administration And Reporting System	N/A	0	Resolved during FY 04.
FY 03	03-FAC-8	The Finance And Administration Cabinet Should Track Federal Expenditures For The Jobs And Growth Tax Relief Reconciliation Act in MARS	N/A	0	Resolved during FY 04.
FY 02	02-FAC-7	The Finance And Administration Cabinet Should Ensure All User Accounts On Its Agency Servers Are Necessary	N/A	0	Resolved during FY 04.
<i>(2) Audit findings not corrected or partially corrected:</i>					
FY 03	03-FAC-2	The Finance And Administration Cabinet Should Strive To Ensure That All State Agencies Conduct Accurate And Timely Fixed Assets Inventory Counts	N/A	0	Not resolved. See 04-FAC-3
FY 03	03-FAC-5	The Finance And Administration Cabinet Should Develop And Implement Formal Policy And Procedures To Govern Security Of The Management Administrative And Reporting System Interface Files	N/A	0	A formal policy and procedures have not been developed or implemented. See 04-FAC-1

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Reportable Conditions (Continued)</u>					
<i>(2) Audit findings not corrected or partially corrected: (Continued)</i>					
FY 03	03-FAC-6	The Finance And Administration Cabinet Should Develop And Apply Formal System Development Life Cycle Procedures For The Commonwealth's Cash And Investments Statistical Analysis System Programs	N/A	0	Follow up work performed for FY 04 revealed that some improvements had been made, but also that there were still significant issues surrounding the program modification procedures. For FY 04, the comment title has been changed to narrow the focus of the remaining issues. See 04-FAC-4
FY 03	03-FAC-7	The Office Of Financial Management Should Improve Segregation Of Duty Controls	N/A	0	Follow-up work performed for FY 04 revealed that there were still three main issues outstanding from FY 03. These issues were split up and 3 formal comments were written. See 04-FAC-5 04-FAC-14 04-FAC-15
FY 02	02-FAC-3	The Finance And Administration Cabinet Should Develop And Consistently Apply Formal Change Management Control Procedures For The Commonwealth's Cash And Investment Statistical Analysis System Programs	N/A	0	See 04-FAC-4
FY 02	02-FAC-4	The Office Of Financial Management Should Improve Segregation Of Duty Controls	N/A	0	See 04-FAC-5 04-FAC-14 04-FAC-15
FY 01	01-FAC-3	The Office Of Financial Management Should Improve Control Procedures Over Modifications To System Programs	N/A	0	See 04-FAC-4

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Reportable Conditions (Continued)

(2) Audit findings not corrected or partially corrected: (Continued)

FY 00	00-FAC-6	The Office Of Financial Management Should Improve Control Procedures Over Modifications To System Programs	N/A	0	See 04-FAC-4
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(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings to report for this section.

(4) Audit finding is no longer valid or does not warrant further action:

FY 03	03-FAC-1	The Finance And Administration Cabinet Should Ensure Proper Classification And Categorization Of Investments In The Cash And Investment Note	N/A	0	Due to improvements, this finding is downgraded to an other matter for FY 04. This finding is no longer required to be reported under Government Auditing Standards.
FY 02	02-FAC-2	The Finance And Administration Cabinet Should Ensure Consistent Classification And Categorization Of Investments In The Cash And Investment Note.	N/A	0	Due to improvements, this finding is downgraded to an other matter for FY 04. This finding is no longer required to be reported under Government Auditing Standards.
FY 01	01-FAC-2	The Finance And Administration Cabinet Should Improve Controls Over Preparation Of The Cash And Investment Note	N/A	0	Due to improvements, this finding is downgraded to an other matter for FY 04. This finding is no longer required to be reported under Government Auditing Standards.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Material Weaknesses</u>					

1) Audit findings that have been fully corrected:

There were no findings to report in this section.

(2) Audit findings not corrected or partially corrected:

There were no findings to report in this section.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings to report in this section.

(4) Audit finding is no longer valid or does not warrant further action:

There were no findings to report in this section.